Senate Bill 495

Implementation, Impacts, and Implications

Part II: Impacts and Implications

Legislative Fiscal Division

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A report prepared for the

Legislative Finance Committee by:

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Part II: Senate Bill 495 – Impacts and Implications

Introduction

This report follows Part I that provided background information on the legislation and reviewed the manner in which the executive is implementing the legislation.

This report examines the impacts and implications of Senate Bill 495 and presents points and issues raised from its implementation by the executive. The methods used to implement the legislation are discussed and the implications of these methods are analyzed. The Legislative Finance Committee is then presented with a summary of issues and actions they may want to consider.

Summary

In response to information presented in Part I, the executive has prepared an agreement that provides documentation of the sale of school trust assets by the Board of Land Commissioners. Implementation of the legislation by the executive causes differences in revenues and expenditures that were unanticipated by the legislature. Analysis indicates the legislation will provide more money for schools in the short-term, but schools will receive less money in the long-term due to the reduction in growth of the school trust. As a result of Senate Bill 495 and House Bill 48 (1999 legislature) the growth in the school trust is nearly stagnant for 30 years. Estimates of mineral royalties and the discount rate are critical in determining the sale price of the mineral production rights. Legal opinions by the Code Commissioner offer guidance to the Legislative Finance Committee in considering issues regarding the methods of implementing the legislation.

New Developments

A major point brought forth in Part I was the lack of a sale agreement between the Board of Land Commissioners, acting in its capacity as fiduciary of the school trust and the seller of school trust assets, and the department as the purchaser. It was the opinion of legislative legal staff that the sale of school trust assets allowed by Senate Bill 495 requires documentation. Due to the lack of such documentation, it could not be determined what was sold and what was purchased.

A meeting between the Legislative Services Division's legal director, Legislative Fiscal Division staff, and representatives of the executive resulted in an understanding that such a document was required. The executive prepared a document (see Attachment A) entitled "Restatement of Purchase and Transfer Pursuant to SB 495" that legislative legal counsel determined meets legal requirements. It documents the sale as being a transfer to the department of "a cumulative revenue stream of state common schools trust mineral royalties, less any amounts necessary for funding the trust land administration account as required by law, equal to $138,894,596".

Although Senate Bill 495 authorized the sale of mineral production rights, a stream of mineral royalties totaling $138,894,596 is what was actually sold. Because this stream of money is not tied directly to mineral rights or specific property owned by the school trust, two key points discussed in Part I are no longer valid:

1. There is no need to distinguish between mineral royalties derived from mineral production rights still owned by the school trust and the mineral royalties derived from the mineral production rights now owned by the department; and
2. There are no additional restrictions as to the amount of mineral royalties that can be diverted to the trust land administration account. If more mineral royalties are diverted, the longer time it will take for the cumulative amount of the stream of mineral royalties that was sold to reach $138,894,596.

This report refers to mineral royalties and mineral production rights interchangeably in reference to the sale of school trust assets authorized by Senate Bill 495.

Impacts and Implications

Expenditures and Revenues

The legislature anticipated that up to $75.0 million would be borrowed from the coal trust and thus appropriated that amount of general fund to the department to purchase school trust mineral production rights. Since the legislation directed the loan amount be deposited to the guarantee account (within the general fund), the legislature included $75.0 million in the general fund revenue estimate.

The methodology used by the executive to make the purchase (transferring ownership of invested funds between the coal trust and the school trust, both within the state treasury, without booking expenditures or revenues) results in anticipated state expenditures and revenues being overstated. Although such actions are lawful, they raise other concerns. The Fiscal Report published by the Legislative Fiscal Division after the 2001 session documents the $75.0 million as a budgeted expenditure and as anticipated revenue. Since neither will occur, any budget comparisons between actual and budgeted amounts in fiscal 2002 using information in this report will be misleading unless the effects of Senate Bill 495 are removed and/or footnoted. Using the examples shown in "Examples" below, at the end of fiscal 2002 one might conclude that general fund revenue was overestimated and that actual revenues collections were short by $75.0 million. Likewise with House Bill 2 appropriations, without taking Senate Bill 495 into account one might conclude wrongly that $75.0 million in general fund was not spent in fiscal 2002 and, therefore, reverted.

Examples

	Estimate Fiscal 2002	Actual Fiscal 2002	Reversion
General Fund Revenue Estimates (millions)			
With $75 million:	$1,405.5	$1,330.5	$75.0
Without $75 million:	$1,330.5	$1,330.5	$0.0
General Fund HB 2 Appropriations (millions)			
With $75 million:	$1,186.3	$1,111.3	$75.0
Without $75 million:	$1,111.3	$1,111.3	$0.0

Timing of Interest Payments

Although Senate Bill 495 directs that loan interest be paid to the general fund annually based on the amount of interest that would be earned on the outstanding loan balance in the prior year, the executive is making monthly payments beginning fiscal 2002. Interest payment cannot be made in fiscal 2002 since in fiscal 2001 (the "prior year") the outstanding loan balance was zero. The amount of the first interest payment is to be determined at the beginning of fiscal 2003 when fiscal year 2002 data is complete. If interest payments were to begin in fiscal 2003, $3.4 million more would be available in the guarantee account for appropriation by the legislature and less would be deposited to the general fund. The Legislative Fiscal Division's general fund balance reported in the Fiscal Report anticipated interest payments to begin fiscal 2003 with additional funds being disbursed to schools and not to the general fund. Legislative legal counsel recommends that interest payments begin in fiscal 2003 once the outstanding balance for fiscal 2002 is known.

Issue 1: Interest payments should begin in fiscal 2003 as provided by SB 495, thus resulting in more revenue in the guarantee account for the legislature to appropriate.

Deposit of Interest Payments

Rather than depositing loan interest payments directly to the general fund, the executive is first transferring the money to the coal trust income fund (an account that receives interest earnings from the coal trust) and then transferring them to the general fund. This causes two effects: 1) the general fund revenue is counted twice, once when revenue is deposited to the guarantee account and once when money in the coal trust income fund is transferred to the general fund. This complicates the reporting of general fund and could lead to misrepresentation of revenues; and 2) coal trust interest earnings deposited to the general fund are overstated by the amount of the loan interest. Legislative counsel recommends that the statute requiring the deposit of the loan interest payments to the general fund be followed.

Issue 2: Interest payments should be deposited directly to the general fund as directed by Senate Bill 495.

Restricted Appropriation

The department is using the $75.0 million general fund appropriation in House Bill 2 to transfer the loan interest payments from the guarantee account to the general fund. This appropriation is restricted only for the "purchase of public school fund mineral production rights". Use of this appropriation for any other purpose violates Section 4 of House Bill 2 that reads in part:

> "An appropriation item designated 'Restricted' may be used during the biennium only for the purpose designated by its title and as presented to the legislature."

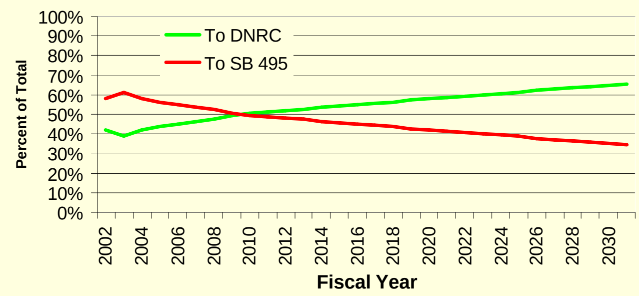
Legislative counsel recommends that all appropriations be used for lawfully intended purposes.

Issue 3: The $75.0 million appropriation should only be used for its lawfully intended purpose.

Disbursement of Mineral Royalties

Although the legislation authorizes the department to purchase mineral production rights from the school trust, the department only used $46.4 million of the authorized $75.0 million to purchase a portion of the stream of mineral royalties. The remaining mineral royalties are diverted to the trust land administration account (established by SB 48 in the 1999 session) and used by the department to fund its trust land operations. The executive elected to do this to ensure their administrative expenses are fully funded (including a 3 percent yearly growth factor) before any mineral royalties are disbursed under Senate Bill 495. In the executive's calculations, mineral royalties diverted to the trust land administration account are 41.7 percent of total estimated mineral royalties in fiscal 2002 and rise to 65.5 percent in fiscal 2031. Because the account receives an increasing percentage of estimated royalties, the percentage disbursed under Senate Bill 495 decreases (Chart 1).

Chart 1
Disbursement of Mineral Royalties



According to 77-1-109, MCA, after deposits into the trust land administration account are made, the remaining mineral royalties are to be deposited into the school trust. However, the department cannot comply with this provision because the remaining mineral royalties have been sold. Legislative legal counsel recommends that 77-1-109, MCA, be amended to clearly specify the intended treatment of mineral royalties.

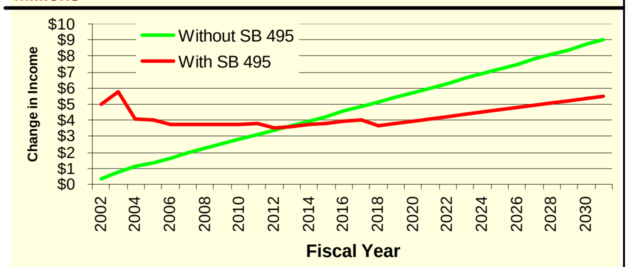
Issue 4: The committee may want to consider legislation to specify the legislative determination as to how the mineral royalties owned by the department are treated with respect to section 77-1-109, MCA.

Short-term vs. Long-term

This sections looks at the long-term implication to the school trust income and to the balance of the school trust due to implementation of Senate Bill 495.

School Trust Income - Senate Bill 495 revises the funding of public schools, thus providing more to schools in the short-term. The mechanism to accomplish this is the sale of school trust mineral production rights at their present value. This results in a one-time infusion of money into the common school trust (95 percent of the interest earnings from which is distributed to schools) and makes net mineral royalties (net of amounts diverted to the trust land administration account and loan interest and principal payments) available for distribution. But, it also eliminates mineral royalty deposits to the school trust that would have generated additional interest earnings, also distributed 95 percent to schools. As implemented by the executive, there is additional money to schools until fiscal 2012. After that time, schools begin to receive less money. By the end of the 30-year period, it is estimated that schools will have received $13.5 million (unadjusted for inflation) less under Senate Bill 495 (Chart 2).

Chart 2
School Trust Income Comparison
Millions

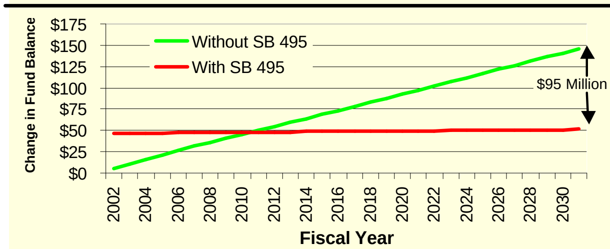


Trust Fund Balance - In the past, there were two primary sources of revenue responsible for increasing the school trust balance: 1) mineral royalties (considered part of the trust corpus); and 2) 5 percent of school trust interest and income that the state constitution directs be deposited to the school trust. However, the growth of the school trust from these two revenue sources has been impacted by two pieces of legislation.

Senate Bill 48 as enacted by the 1999 legislature allows the diversion of the 5 percent of school trust interest and income and the diversion of a portion of school trust land mineral royalties to the trust land administration account. Senate Bill 495, as implemented by the executive, removes the remaining $139.8 million of mineral royalties not diverted by Senate Bill 48 through fiscal 2031. Therefore, the only remaining growth potential for the school trust for the next thirty years is from the sale of right-of-ways, easements, miscellaneous assets, and the portion of the 5 percent of interest and income not diverted to the trust land administration account.

Without Senate Bill 495, it is estimated that the $138.9 million in mineral royalties would have grown to $145.9 million at the end of 30 years due to the return of 5 percent of interest earnings from the mineral royalties. With Senate Bill 495, it is estimated that the $46.4 million paid for the $138.9 million stream of mineral royalties will grow to $51.2 million over this same period. As projected by the executive, the school trust balance at the end of the 30-year period will be $94.7 million less under Senate Bill 495 (Chart 3). Given the speculative nature of mineral royalty projections, this difference could vary.

Chart 3
School Trust Balance Comparison
Millions



Because of the reduced growth in the trust balance, the growth in interest earnings is also reduced as shown in Chart 2.

Value of Mineral Production Rights

In order to sell a portion of school trust mineral production rights, the present value of the assets had to be determined. This requires: 1) the length of time the mineral production rights are to be purchased; 2) estimates of the mineral royalties to be purchased; and 3) a discount rate. Each of these three important aspects is discussed below.

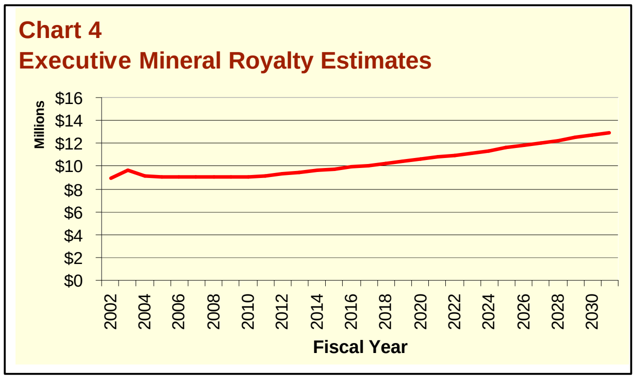
1. Length of Time

The executive estimates that mineral production rights will be purchased for 30 years. If mineral royalties are greater than estimated, the time period may be reduced. If they are less, the time period may be extended.

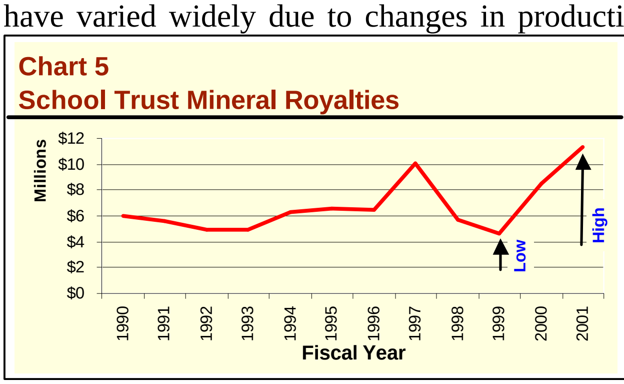
2. Mineral Royalties

Estimation of the yearly amounts of mineral royalties over 30 years is a critical element for determining the full market value of the school trust mineral production rights to be sold.

Chart 4 shows the executive estimates of mineral royalties over 30 years. The methodology used to determine these estimates uses HJR 2 estimates, an average for mineral royalties plus other income,



and mathematical computations involving an increasing amount of mineral royalties diverted to the trust land administration account. The average of the executive mineral royalty estimates over the next 30 years are $10.3 million, with a low of $8.9 million and a high of $13.0 million. Although it is difficult to estimate mineral royalties over a 30-year period, the executive did not base the estimates on available long-range forecasts of mineral prices, historical production, current producing leases, anticipated future production from current leases, or production from potential future leases. History shows there are large fluctuations in mineral royalty receipts from school trust lands. Over the last 12 fiscal years, mineral royalties from school trust lands have averaged $6.8 million (Chart 5), but collections have varied widely due to changes in production



amounts and value of the extracted minerals. The standard deviation over this period is about $2.1 million or 31 percent of the average.

Changes in the mineral royalty estimates would cause substantial changes in the sale price. As shown in "Change in Mineral Royalties" below, a yearly increase of 20 percent in estimated mineral royalties would increase the sale price by $7.3 million while a decrease of 20 percent would decrease the sale price by $8.1 million. The changes shown are for approximately the same purchase amount and are well within the historical 31 percent deviation.

Change in Mineral Royalties
(Millions)

Yearly Change in Royalties	Purchase Amount	Purchase Price	Price Difference	Length of Time
20.00%	$139.846	$53.673	$7.306	25 Years
10.00%	$138.029	$50.024	$3.657	27 years
0.00%	**$138.895**	**$46.367**	**$0.000**	**30 Years**
-10.00%	$137.077	$42.336	($4.031)	33 Years
-20.00%	$139.732	$38.252	($8.115)	38 Years

The difficulty in estimating mineral royalties over a lengthy period of time due to uncertainties in price and production is one reason why the federal government prohibits the sale of the mineral estate from any school trust lands the state received under the Enabling Act to any non-state entity. Since the amount and presence of minerals are not known for all school trust lands, the difficulties and uncertainties in estimating the present value of the school trust mineral estate make it an inherently speculative process.

3. Discount Rate

A discount rate is used to determine the present value of an investment. By calculating the present value of an investment's future cash flow, one can determine the worth of the investment at the present. By determining the present value of multiple potential investments, an investor can make comparisons to determine which one is most profitable.

The $46.4 million value for the mineral production rights was calculated based on a discount rate of 9.81 percent and a 30-year stream of mineral royalties as shown in Chart 4 above. Because no other comparable sale of mineral royalties could be found as a guide due to the uniqueness of the asset being sold, the discount rate was determined by comparisons to financial investments such as treasury bills, historical yields of a large stock portfolio, and Standard and Poor's BBB rated corporate bonds.

Under Senate Bill 495, the Board of Land Commissioners had two investment options: 1) do not sell the mineral production rights and continue to deposit the mineral royalties into the school trust; and 2) sell the mineral production rights at a discounted rate and deposit the proceeds in the school trust. In either option, the money in the school trust (either from mineral royalties or the sale proceeds) would earn interest based on long-term interest rates obtained by the Board of Investments on the trust funds bond pool.

The Board of Land Commissioners chose the second option that yields $46.4 million in sale proceeds plus an estimated $266.1 million in interest earnings (a total of $312.5 million) over 30 years. The first investment option would yield a total of $138.9 million in mineral royalties plus an estimated $301.1 million in interest earnings (a total of $440.0 million) over 30 years. The difference of $127.5 million between the options results from the discount rate used by the executive. The discount rate is a measure of the perception of risk in the stream of mineral royalties and thus determines the price at which the Board of Land Commissioners would be willing to sell them.

Instead of choosing the more speculative total of $440.0 million, the Board of Land Commissioners chose the less risky total of $312.5 million over 30 years.

The discount rate is a very important component in determining the value of the mineral production rights since a small change in the rate can make a substantial change in the value. For example, if the discount rate had been one percentage point lower, the purchase price would have been $4.0 million more and that much more would have been deposited to the school trust (see "Discount Rate Examples" below). If it had been one percentage point higher, the school trust would have received $3.5 million less.

Discount Rate Examples
(Millions)

Rate	Purchase Price	Difference
10.81%	$42.908	($3.459)
10.31%	$44.577	($1.790)
9.81%	**$46.367**	**$0.000**
9.31%	$48.289	$1.922
8.81%	$50.357	$3.990

Point: The value of the mineral production rights is sensitive to changes in estimates of mineral royalties and the discount rate. The potential for inaccuracies in these estimates makes the sale of mineral production rights an inherently speculative process.

Importance of Receiving Full Market Value

The amount the school trust receives from the sale of the mineral royalties is important because the Montana Constitution requires that full market value be received from the sale of trust assets (see "Montana State Constitution, Article X").

Montana State Constitution, Article X

Section 3. Public school fund inviolate. The public school fund shall forever remain inviolate, guaranteed by the state against loss or diversion.

Section 11. Public land trust, disposition.
(2) No such land or any estate or interest therein shall ever be disposed of except in pursuance of general laws providing for such disposition, or until the full market value of the estate or interest disposed of, to be ascertained in such manner as may be provided by law, has been paid or safely secured to the state.

Corrections
The word "department" is undefined in the legislation. The executive interpreted the word to mean the Department of Natural Resources and Conservation.

Issue 5: The word "department" should be defined in statute.

Issue Summary and Options

Issue 1: Interest payments should begin in fiscal 2003 as provided by SB 495, thus resulting in more revenue in the guarantee account for the legislature to appropriate.

Option: Advise the executive to begin interest payments in fiscal 2003 (rather than in fiscal 2002) as directed in Section 3 of Senate Bill 495. This would result in more money deposited into the guarantee account and less to the general fund.

Issue 2: Interest payments should be deposited directly to the general fund as directed by Senate Bill 495.

Option: Advise the executive to deposit loan interest payments directly to the general fund as required by statute.

Issue 3: The $75.0 million appropriation should only be used for its lawfully intended purpose.

Option: Advise the executive not to use the line item House Bill 2 appropriation for transferring interest payments to the general fund as this does not appears to be a legal use of the appropriation.

Issue 4: The committee may want to consider legislation to specify the legislative determination as to how the mineral royalties owned by the department are treated with respect to section 77-1-109, MCA.

Option: Determine if the mineral royalties addressed by Senate Bill 495 should be used to fund the trust land administration account. Sponsor a committee bill to direct that the remaining mineral royalties, after deposits into the trust land administration account are made, are to be deposited into the school trust or sold in accordance to Senate Bill 495.

Issue 5: Define the word "department".

Option: Draft a committee bill to define "department" as being the Department of Natural Resources and Conservation. This is a technical correction to Senate Bill 495.

Attachment A

“Restatement of Purchase and Transfer Pursuant to SB 495”

RESTATEMENT OF PURCHASE AND TRANSFER PURSUANT TO SB 495

WHEREAS, Senate Bill 495 enacted by the 2002 Legislature authorized the transfer and purchase by the Department of Natural Resources and Conservation of a stream of revenue derived from trust lands mineral royalty (referred to as "mineral production rights held by the public school fund") held by the State Board of Land Commissioners;

WHEREAS, Section 4 of Senate Bill 495 of the 2001 Legislative Session provided that:

> **Section 4. Purchase of permanent fund mineral estate.** The department of natural resources and conservation may purchase the mineral production rights held by the public school fund established in Article X, section 2, of the Montana constitution for fair market value. If the department of natural resources and conservation purchases mineral production rights, any royalty payments received by the board that are not used to reimburse the coal severance tax trust fund for the loan used for purchasing the mineral production rights must be deposited in the guarantee account provided for in [section 3].

WHEREAS, the Department of Natural Resources entered into a Loan Agreement (a copy of which is attached hereto as Exhibit "A") with the State Board of Investments on July 1, 2001, pursuant to the authority of SB 495 and the approval of the State Board of Land Commissioners;

WHEREAS, the June 18, 2001 minutes of the State Board of Land Commissioners (a copy of which is attached hereto as Exhibit "B") and Agenda Item #601-4 (a copy of which is attached hereto as Exhibit "C") evidence that the Board approved the above-described loan agreement;

WHEREAS, the Loan resulted in $46,366,904 being placed into the common schools permanent fund;

NOW, THEREFORE, the State Board of Land Commissioners, in exchange for the above referenced loan amount, hereby transfers to the Department of Natural Resources and Conservation, effective as of July 1, 2001, a cumulative revenue stream of state common schools trust mineral royalties, less any amounts necessary for funding the trust land administration account as required by law, equal to $138,894,596. The Department must utilize the royalty revenue stream to: 1) pay the loan principal and interest pursuant to the terms of the referenced loan agreement; and 2) distribute the remainder to the guarantee account referenced in Section 4 of SB 495.

DATED this ___ day of February, 2002.

STATE OF MONTANA and STATE BOARD OF LAND COMMISSIONERS

By___________________________________

JUDY MARTZ
Governor of the State of Montana

(GREAT SEAL OF
THE STATE OF MONTANA)

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BOB BROWN
Secretary of State

(SEAL OF THE
SECRETARY OF STATE)

____

ARTHUR R. CLINCH
Director, DNRC

(SEAL OF THE STATE
BOARD OF LAND COMMISSIONERS)